



University of Groningen

## Handel en Diplomatie

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## Summary

### TRADE AND DIPLOMACY

This thesis explores the relevance and possibilities of an approach which takes political circumstances explicitly into account in explaining international trade.

Chapter 1 discusses the need for renewed interest in political influences that shape the world economic system. Although the merits of specialization have to be acknowledged, it appears that no substantial arguments exist for the presently very strict demarcation between foreign policy and trade theory.

Twentieth century trade theorists in general seem to have completely banned political variables from their analytic framework. Chapter 2 explores the history of economic thought in order to understand why politics and economics have been divorced in the study of international relations. It appears that classical and pre-classical authors as well as marxist writers paid a lot of attention to the political consequences and incentives of international economic relations. For the "founding fathers" of international free trade theory, Smith, Ricardo and J.S. Mill, political and economic relations were very much interrelated. The integrated approach, however, has been abandoned in the twentieth century and two separate sciences have evolved out of Political Economy. The elimination of political variables from economic theorizing can be traced back to the works of Marshall, Robbins and Eucken. An explanation based on the sociology of economics may, however, also be appropriate, as the professional economist's need for tribal delineation clearly contributes to pure theoretical analysis that is unrelated to the real world. Anyhow, recent international trade theory has shed insufficient light on political influences.

In Chapter 3 a small trading economy is studied that faces given terms of trade in combination with an uncertain volume of trade. It is shown that an increase in the probability of trade disruption forces both public and private decision makers to specialize to a lesser extent in accordance with their comparative advantage, and hence to restrict the potential for international trade. Since expectations about future trading conditions depend to a large extent on the bilateral political climate, the testable proposition results that an improving (deteriorating) bilateral diplomatic climate, *ceteris paribus*, increases (decreases) the bilateral trade flows.

Chapter 4 tests this proposition by means of a cross section gravity analysis that pertains to the bilateral trade flows of 40 countries in the year 1985. The empirical results show a significant statistical relationship between the trade flows and the diplomatic climate. This relationship was also established on the basis of 40 import and 40 export equations for the individual countries vis-à-vis their 39 trade partners. It appears that Western market economies adjust their exports in reaction to diplomatic events, whereas the centrally planned economies adjust their imports. It can be concluded that the political variables contribute significantly to the explanation of the world's trade structure.

The question of the existence of an empirical relationship between trade flows and the diplomatic climate being answered affirmatively, Chapter 5 discusses the use of international economic relations as a means to attain foreign policy goals. A formal model studies an expected utility maximizer who faces the possibility of a profitable act of misconduct which is heavily resented by other countries. The conditions under which positive sanctions (conditional rewards) and negative sanctions (conditional punishments and threats) influence the decision unit's behaviour are investigated. Postulating different shapes of the utility function makes it possible for the analysis to cover the wide range of decision entities varying from cautious to risk-loving ones. The willingness of an expected utility maximizing actor to antagonize the rest of the world can be influenced both by positive sanctions and negative sanctions, and by measures that enlarge

the actor's subjective probability that sanctions will be executed upon misconduct. Enlargement of the (unconditional) yield of neutral activities induces the risk averter to engage in misconduct, whereas risk-neutral or risk-loving actors are constrained by such a measure. Hence in the international arena of politics economic incentives can only be effective when they are conditional upon the absence of misconduct.

Our practical experience with economic sanctions as a tool of international politics is ambivalent. Since opinions *pro* and *contra* the effectiveness of sanctions are based on biased selections of case studies, the scientific debate lacks both clarity about how sanctions work and a solid empirical foundation. To alleviate these deficiencies Chapter 6 presents a review of literature and some empirical findings. A logit analysis based on the data of a recent study by Hufbauer and Schott correctly predicts failure and success in 83% out of 80 sanctions in the years 1946–1983. The probability that an economic sanction succeeds is higher the larger the pre-sanction trade linkage, the more unstable the target's political situation and the shorter the sanction period. Concerning the sanctioner's reputation as an executioner of threats, it was found that the positive marginal influence of the number of prior threats diminishes and even turns negative after a certain number.

Hence based on both theoretical and empirical analysis it has to be concluded that a negative economic sanction can be an effective instrument of foreign policy, provided that certain conditions are met. This finding in itself offers indirect support for traditional trade theory, as a negative economic sanction implies a (potential) welfare loss and hence constitutes a strong incentive to adapt behaviour.

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